Supreme Court, U.S.
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92-No.1907

IN THE

Supreme Court of the United States

OCTOBER TERM, 1992

HUNTINGTON BREAKERS APARTMENTS, LTD.,
a partnership,
Petitioners,
vs.
C.W. DRIVER, a partnership,
Respondent.

PETITION FOR WRIT OF CERTIORARI
TO THE CALIFORNIA COURT OF APPEALS
FOURTH APPELLATE DISTRICT, DIVISION THREE

PETITION FOR WRIT OF CERTIORARI

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QUESTION PRESENTED FOR REVIEW

Should an illegal side agreement that violates the principle of ***D'Oench, Duhme v. FDIC***, 315 U.S. 447 (1942) be enforcd by the Courts, merely because that illegality was not raised in an arbitration?

STATEMENT PURSUANT TO

SUPREME COURT RULE 29.1

Petitioner WILMORE CITY DEVELOPMENT, INC. has no parent or subsidiary company.

PARTIES TO THE PROCEEDING

All parties to the proceeding are listed in the caption.

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HUNTINGTON BREAKERS APARTMENTS, LTD., a partnership, et al.,
Petitioners,

vs.

C.W. DRIVER, a partnership,
Respondent.

PETITION FOR WRIT OF CERTIORARI

Petitioners HUNTINGTON BREAKERS APARTMENTS, LTD., a partnership; WILMORE CITY DEVELOPMENT, INC., and JOSEPH P. MAYER III (hereinafter "HUNTINGTON BREAKERS") respectfully pray that a writ of certiorari issue to review the opinion of the Court of Appeal, Fourth Appellate District of the State of California. A Petition for Review was denied by the California Supreme Court, by Order filed February 24, 1993 (Appendix A hereto).

OPINION BELOW

The Court of Appeal, Fourth Appellate District, of the State of California by its Opinion (Appendix B hereto) reversed an Order of the Superior Court of Orange County (Appendix C hereto) which had found a ***D'Oench Duhme*** type contract to be illegal. That reversal was based upon a recent opinion of the California Supreme Court, ***Moncharsh v. Heily and Blase*** (1992) 3 Cal.4th 1, 10 Cal.Rptr. 2d 183.

JURISDICTION

This Court has jurisdiction to review this matter pursuant to ***28 U.S.C.*** §2101(c) and Rule 10.1(b) of the Supreme Court Rules.

/ / / /

/ / / /

LEGAL PRINCIPLE INVOLVED

This case involves the primary issue of whether the illegality of a contract that violates the ***D'Oench Duhme (supra)*** rule, which requires the protection of federally insured financial institutions from the effect of illegal contracts, should take precedence over the waiver established by the California Supreme Court in its recent opinion in ***Moncharsh***.

STATEMENT OF THE CASE

In March of 1983, five people (Steven P. Semingson and his wife, Joseph P. Mayer III and his wife, and Daniel H. Young) joined together to form HUNTINGTON BREAKERS APARTMENTS, LTD., a California limited partnership ("BREAKERS"). A portion of that partnership interest was held in the name of another entity,

Wilmore City Development, Inc. On May 1, 1984, BREAKERS, as owner, entered into an American Institute of Architects (A.I.A.) form construction contract with C.W. DRIVER, a large general contractor in business since 1935, to construct for the five people a 342-unit apartment complex in Huntington Beach. The amount of that contract was $8.6 million. The project was financed by a federally insured and supervised lender Home Federal Savings & Loan. As a condition to DRIVER's execution of the A.I.A. form contract, DRIVER required all five individuals to also sign a side agreement entitled "Guarantee and Indemnity Agreement," prepared by DRIVER's attorney, Everett Maguire, which ostensibly increased the exposure of the S&L from $8.6 million to $11 million. This side agreement was not

a part of the S&L's file. The contractor represented to the lender that it would construct the project for the funds remaining in the loan.

After a dispute arose over the performance of the construction contract, DRIVER recorded a Mechanic's Lien, stopped work on the project and sued BREAKERS and the five individuals. DRIVER petitioned to compel arbitration under a hidden arbitration clause, buried in an attachment to the AIA form construction contract. The Guarantee and Indemnity Agreement contained no provision for arbitration. BREAKERS and the five individuals filed a cross-complaint against DRIVER for breach of contract, negligence, breach of fiduciary duty, fraud, negligent misrepresentation, declaratory relief, action on performance

and payment bonds, and injunction. The Superior Court granted DRIVER's motion to compel arbitration and ordered part of the action into arbitration. The guarantors were excluded from the arbitration. The arbitrators awarded DRIVER $3,021,502 consisting of contractual damages, pre-award interest, and costs and attorneys' fees. The total of the contractual damages awarded and the amounts paid to DRIVER under the contract exceeded the $8.6 million A.I.A. form contract amount. Also, there was no provision for attorneys fees in the AIA Form Agreement.

BREAKERS filed a Petition to Vacate Arbitration Award based on the illegality of the Guarantee and Indemnity Agreement and bias of the arbitrators. BREAKERS contended that the Guarantee and

Indemnity Agreement, which was prepared by DRIVER, concealed the true cost of construction from the construction lender, a federally insured institution, in violation of federal statutes and United States Supreme Court decisions. On July 12, 1991, the Superior Court granted BREAKERS' motion and found:

> "... that those portions of the contract document entitled 'Guaranty and Indemnity Agreement' ... that obligate the parties making that agreement to payment of any contractor-construction costs over and above the $8.6 million guaranteed maximum cost stated in the AIA Form Agreement

> constitute an illegal contract and are unenforceable."
> (Appendix C, p.8.)

DRIVER appealed that Order.

On July 30, 1992, prior to the presentation of oral argument by BREAKERS and DRIVER before the Court of Appeal, the California Supreme Court decided the case of ***Moncharsh***. That Court held that the arbitrator's award was not subject to judicial review because the issue of illegality had not been raised in an arbitration.

Based on the ***Moncharsh*** decision, the Court of Appeal in this case reversed the Superior Court's Order to Vacate Arbitration Award. (Opinion, Appendix B, p.4.) The California Supreme Court declined to review that opinion.

(Appendix A)

BREAKERS now petitions this Court for a review of that opinion by the Court of Appeal.

REASONS FOR GRANTING THE WRIT

SETTLEMENT OF IMPORTANT QUESTIONS OF LAW

There are important questions of law in this case that were not settled by the Court of Appeal's opinion. The principal issue of the appeal was the finding by the Superior Court that the Guarantee and Indemnity Agreement prepared by DRIVER was "illegal and unenforceable." The illegality involved issues of federal law, namely the violation of ***18 U.S.C.*** § 1014 as well as California Law (Fin. Code § 5308). It also involved established public policy in favor of full disclosure of a project's cost when the lender was a federally insured institution. That

public policy was affirmed in the recent Ninth Circuit case of ***Federal Savings & Loan Ins. Corp. v. Gemini Management*** 921 F.2d 241 (9th Circuit 1990), wherein that Court stated at page 244:

> "In 1942, the Supreme Court articulated a rule designed to implement a 'federal policy to protect [the FDIC] and the public funds which it administers against misrepresentations as to the securities or other assets in the portfolios of the banks which [the FDIC] insures or to which it makes loans.' ***D'Oench Duhme & Co. v. FDIC***, 315 U.S. 447, 457, 62 S.Ct.

676, 679, 86 L.Ed. 956 (1942). This policy is as sound today [1990] as it was in 1942, if not more so." (Emphasis added)

The 9th Circuit Court in ***Gemini*** then brought the ***D'Oench*** doctrine up to date (1990) by stating at page 245:

"These words are particularly meaningful today. As the Savings and Loan crisis in which this nation is mired continues to unfold, regulators are discovering abuses the *D'Oench* Court could not have imagined or predicted. The FSLIC's

> ability to evaluate the financial condition of troubled thrift institutions depends, now more than ever, upon the protective shield of *D'Oench*.
>
> "We cannot condone a transaction with the capacity to deceive the banking regulators, nor can we reward [the parties] for their creative and deceptive paperwork."

The Court of Appeal did not even consider the issue of whether the Guarantee and Indemnity Agreement was illegal as a matter of law. That issue had been submitted and argued to that

Court. It reasoned, pursuant to ***Moncharsh***, that since it was contended by BREAKERS that the guarantee was severable, and because illegality had not been raised as an issue during arbitration, "[BREAKERS'] failure to raise the issue of illegality precluded any future judicial review." (Opinion, Appendix B, p.18.)

However, the illegality described in ***Moncharsh*** was not the same as the illegality that is the subject of this Petition. First, there were no federal questions involved, and secondly, statutory rights of non-parties were not an issue. By not addressing the issue of illegality, the Court of Appeal erroneously applied the rule in ***Moncharsh*** to the facts of this case.

Even though the California Supreme

Court in ***Moncharsh*** suggested that, under the circumstances of that case, illegality of a portion of a contract is waived by the affected party if not raised during arbitration, Petitioners submit that the result should not be the same when illegality is based on a violation of federal statutes and recognized public policy.

ILLEGALITY OF THE GUARANTEE AND INDEMNITY AGREEMENT SHOULD HAVE BEEN CONSIDERED BY THE COURT OF APPEAL BECAUSE IT WAS THE PRINCIPAL ISSUE OF THE APPEAL

The basis for the Superior Court's July 12, 1991 Order Vacating Arbitrator's Award (Appendix C) was a finding cited in the Court of Appeal's opinion (Appendix B, p. 7) as follows:

"In its judgment, the

> court found 'that those portions of the contract document entitled 'Guaranty [sic] and Indemnity Agreement' . . . that obligate the parties making that agreement to the payment of any contractor-construction costs over and above the $8.6 million guaranteed maximum cost stated in the AIA Form Agreement constitute an illegal contract and are unenforceable."
>
> [Emphasis added.]

It was this "finding" of illegality that was the basis of the appeal by

DRIVER. However, the Court of Appeal did not address this issue in its opinion and did not articulate any reasons for not addressing this issue. In reading the opinion, however, it appears that the Court considered the issue moot, since the illegality was deemed severable, and it had not been raised during arbitration.

The Court of Appeal (Appendix B, p.18) stated:

> "Here, Breakers contended, and continues to contend, that the guarantee was severable, so that other provisions could survive a finding that portions of the guarantee are illegal. Thus, its failure to

raise the issue of illegality precluded any future judicial review."

THE *MONCHARSH* OPINION, RENDERED IN THE CONTEXT OF WHAT THE CALIFORNIA SUPREME COURT DETERMINED TO BE A PRIVATE DISPUTE, OUGHT NOT EXTEND TO CASES REQUIRING JUDICIAL PROTECTION OF STATUTORILY-BASED NON-PARTY PUBLIC INTERESTS

The California Supreme Court has, for more than fifty years, declared as illegal and unenforceable contracts between private party litigants when the Court perceives that the Court must be the source of protection for the public's interest, regardless of the desires of the litigants or the procedural history of the cases before the Court. (See

McAllister v. Drapeau (1939) 14 Cal.2d 102, 92 P.2d 911.)

Accordingly, the statutory interest of the public, and of financial institutions which serve the public interest, are not matters that can be relegated to the voluntary submission of the dispute to arbitrators. The public was not party to that submission, yet the public must be protected by judicial deterrence of illegal conduct.

In ***McAllister v. Drapeau***, the California Supreme Court held that an undisclosed "secret" side agreement between the private contracting parties "violates the basic public policy expressed in the act [The Home Owners' Loan Act of 1933]" (***Id.*** at 109) and "is tantamount to a fraud on the [government]". (***Id.*** at 111).

In ***Young v. Hampton*** (1951) 36 Cal.2d 799, 228 P.2d 1, 19 A.L.R.2d 830, the California Supreme Court protected the non-party public interest. The ***Young*** Court, citing ***McAllister (supra)*** and other cases, stated that "the policy announced in these decisions of affording the protection of the law to those whom the federal loan statutes are designed to benefit is a sound one..." (***Id.*** at 805.)

Another concurrent construction case, ***Pitts v. Highland Construction*** (1953) 115 Cal.App.2d 206, 252 P.2d 14, consistently held that in cases involving the public interest in honest dealing with public financing (or publicly guaranteed bank financing), California courts will not enforce side agreements that require payment of higher amounts than the amount disclosed to the lending

bank as the full cost of the project. Perhaps because none of ***McAllister, Young*** and ***Pitts*** cases involved arbitration, the doctrine of public policy protection for which they stand was not considered by the California Supreme Court in its ***Moncharsh*** opinion. Yet, because of today's near-exclusive predominance of arbitration clauses in the printed form contracts published by professionals in the building industry, this Court should anticipate that the vital ***McAllister, Young*** and ***Pitts*** line will die if the ***Moncharsh*** opinion can be taken to say that courts will no longer review contracts that are partially illegal (i.e. the "secret" part prepared by the contractor builder and not disclosed to the housing lender). This Court can and should expressly recognize that the

Moncharsh opinion does not address and should not be precedent for "illegality" cases involving statutorily based public policy interests of non-parties. The modern cases in this area are arising through arbitration.

The case law protecting the public interest, in this area of bank lending for housing, falls squarely within the prospective exception recognized in ***Moncharsh*** (at page 53) that judicial review may be had for protection of a right having "an explicit legislative expression of public policy." (*Id.*) Therefore, when the exception involves not a "party's statutory rights" (*Id.*) but the statutory rights of the non-party public, the basis for ***Moncharsh*** should not apply.

Notwithstanding ***Moncharsh***, an

arbitration award should not be based on an agreement that violates federal law and policy. (See ***Perez v. Campbell*** (1971) 402 U.S. 637, 91 S.Ct. 1704, 1711, 29 L.Ed. 2d 233, 242; ***Bothman v. Ukiah*** (1989) 216 Cal.App.3d 1395, 1408, 265 Cal.Rptr. 539.)

CONCLUSION

Petitioners HUNTINGTON BREAKERS believe that the current economic situation relating to illegal contracts that defraud federally insured financial institutions should warrant the interest of this Court sufficiently to grant certiorari.

A review of recent action by this Court involving the ***D'Oench Duhme*** doctrine indicates that this Court is interested in not diluting that doctrine in any way. Examples are Docket No. 92-

428 ***Graff v. Bank One***, Texas N.A. (61 LW 3288, review denied January 11, 1993, 61 LW 3477), Docket No. 92-840 ***Pacific Southwest Bank F.S.B. v. Bradley,*** (61 LW 3447, review denied March 9, 1993), Docket No. 92-935 ***Ward v. Resolution Trust Corp.*** (61 LW 3512), and Docket No. 91-1856 ***Triple M Drilling Co. v. Seider,*** (61 LW 3002; review denied October 5, 1992, 61 LM 3256).

The Court of Appeal, by following ***Moncharsh*** in this case, disregarded the overriding requirement of protecting federally insured financial institutions. Petitioners submit that this Court should grant this Petition.

Respectfully submitted,

CALLAHAN, McCUNE & WILLIS

GEORGE W. COLEMAN

APPENDIX A

Supreme Court
FILED
Feb 24 1993
Robert Wandruff Clerk
H. Cruz
Deputy

Fourth Appellate District,
Division Thre
No. G011323
S030278

IN THE SUPREME COURT OF
THE STATE OF CALIFORNIA

IN BANK

C. W. DRIVER, Appellant

v.

HUNTINGTON BREAKERS APARTMENTS LTD. Et Al., Appellants

And Companion Case

Appellants' petition for review DENIED.

/LUCAS/

Chief Justice

APPENDIX B

COURT OF APPEAL
4TH DISTRICT
DIVISION 3
NOV 6 1992

Deputy Clerk

NOT TO BE PUBLISHED

IN THE COURT OF APPEAL

OF THE STATE OF CALIFORNIA

FOURTH APPELLATE DISTRICT,

DIVISION THREE

C.W. DRIVER,

Plaintiff and Appellant,

v.

HUNTINGTON BREAKERS APARTMENTS,

LTD etc.,

Defendants and Appellants.

G011323

(Consol. with G011659)

(Super. Ct. No. 477394)

OPINION

APPEAL from a judgment of the Superior Court of Orange County, Robert A. Knox, Judge. Reversed.

Maguire, Toghia & Orbach, Everett W. Maguire, Stephen L. Chesney, Robyn K. Cossack and Jay Sherman for Plaintiff and Appellant.

Callahan, McCune & Willis, George W. Coleman and Steven A. O'Rourke for Defendants and Respondents.

* * *

In 1986, the superior court granted C. W. Driver's motion to compel arbitration of a contract dispute. Four years and over 130 hearings later, three arbitrators unanimously awarded Driver $3,021,502. However, in 1991 the superior court vacated the award, based upon the alleged illegality of a collateral guarantee executed by Huntington Breakers Apartments, Ltd.[1]

Driver seeks reversal of an order granting Breakers' petition to vacate the arbitration award. Breakers appeals an

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[1] Driver is a California general partnership and a building contractor composed of three California corporations, C.W. Driver, Inc., John Tyler, Inc. and Somers Financial, Inc. (collectively Driver). Huntington Breakers apartments, Ltd. is a California limited partnership with two general partners, Wilmore City Development, Inc. (Wilmore), a California corporation, and Joseph P. Mayer (Mayer) (collectively Breakers).

order granting Driver's motion to strike its memorandum of costs in which it sought $2,262,759.41 in fees and costs.

The Supreme Court's decision in Moncharsh v. Heily & Blase (1992) 3 Cal.4th 1 requires reversal.

FACTS

This case arises out of a dispute over the construction of a 342-unit apartment complex in Huntington Beach. Driver, a contractor, and Breakers, real estate developers and the owners of the property, entered into an American Institute of Architects (AIA) form construction contract on May 4, 1984, pursuant to which Driver agreed to construct the apartment complex. The contract incorporated "general conditions" by reference, providing for

arbitration of contractual disputes. At the time of the execution of the contract, Driver and Breakers entered into a guarantee and indemnity agreement. The contract itself provided that the maximum cost to the owner, Breakers, including the cost of Driver's work and contractor's fee, was guaranteed not to exceed $8,600,000. However, the guarantee and indemnity agreement, prepared by Driver, provided that Breakers' maximum obligation could not exceed $11,000,000 plus increased construction costs which might result from revisions and modifications required by the city or from changes and extra work requested by the owner or lender.

A dispute arose over the performance of the construction contract and, on December 26, 1985, Driver filed a

complaint for foreclosure of mechanic's lien and a petition to compel arbitration and stay the action pending the outcome of that arbitration. Breakers and others filed a cross-complaint against Driver for breach of contract, negligence, breach of fiduciary duty, fraud, negligent misrepresentation, declaratory relief, action on performance bond and payment bond, and for injunction. The superior court severed a portion of the litigation and ordered it into arbitration. Arbitration began shortly thereafter but ultimately involved more than 130 days of hearings over a period of four years[2], concluding in a unanimous

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2 This is the second time we have reviewed aspects of this apparently never-ending case. In a prior unpublished opinion (G009921), we affirmed the dismissal of Breakers' second amended cross-complaint against other parties for failure to serve the

award for driver of $1,500,535, plus pre-award interest of $304,398 and costs and attorney's fees of $1,141,469, for a total award of $3,021,502.

Thereafter, Breakers filed a petition to vacate the award, contending the contract was illegal, that the arbitrators were biased, and that improper parties were ordered to participate in the arbitration. On April 8, 1991, the superior court granted Breakers' motion to vacate the award on the ground that the contract was illegal. In its judgment, the court found 'that those portions of the contract document entitled 'Guaranty [sic] and Indemnity

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cross-complaint within three years. This case is not model example of "the purpose of arbitration -- to provide a speedy and inexpensive trial before commercial specialists." (Green v. Mt. Diablo Hospital Dist. (1989) 207 Cal.App.3d 63, 70.)

Agreement' . . . that obligate the parties making that agreement to the payment of any contractor-construction costs over and above the $8.6 million guaranteed maximum cost stated in the AIA Form Agreement constitute an illegal contract and are unenforceable." Driver's appeal followed.

Breakers filed a motion seeking attorney's fees and costs. The court granted Driver's motion to strike the memorandum of costs and Breakers' appeal followed.

DISCUSSION

Following the briefing in this matter, we permitted the parties to file supplemental briefs on the applicability of the Supreme Court's decision in Moncharsh v. Heily & Blase, supra, 3

Cal.4th 1 (hereafter Moncharsh), which was decided July 30, 1992.[3] In Moncharsh, an attorney terminated his employment with a law firm, but continued to represent clients who had signed retainer agreements with his former firm. A dispute arose regarding the firm's quantum meruit claim for fees and a percentage of the fees pursuant to a fee-splitting provision of the former employment contract. The parties submitted the dispute to arbitration and, although the attorney claimed the fee-splitting provision was illegal, the arbitrator ruled in favor of the law firm and the trial court granted the firm's

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3 Of course, the rule in Moncharsh is binding upon this court and must be applied retroactively to this case. (See Moradi-Shalal v. Fireman's Fund Ins. Companies (1988) 46 Cal.3d 287, 305; Peterson v. Superior Court (1982) 31 Cal.3d 147, 151-152.)

petition to confirm the award. (Id. at pp. 6-8.) The Court of Appeal affirmed, recognizing the general rule prohibiting review of the merits of an arbitrator's award, and the Supreme Court affirmed. (Id. at p. 8.)

The Supreme Court noted that in a private or nonjudicial arbitration, the scope of the arbitration is a matter of agreement between the parties and the arbitrator's powers are limited by agreement or stipulation. (Moncharsh, supra, 3 Cal.4th at p. 8; see also Ericksen, Arbuthnot, McCarthy, Kearney & Walsh, Inc. v. 100 Oak Street (1983) 35 Cal.3d 312, 323; O'Malley v. Petroleum Maintenance Co. (1957) 48 Cal.2d 107, 110.)[4] The court noted, in a detailed

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[4] At oral argument, Breakers' counsel argued for the first time that an April 14, 1986 letter to Driver's counsel

analysis of the history of arbitration, that "the Legislature has expressed a 'strong public policy in favor of arbitration as a speedy and relatively inexpensive means of dispute resolution.'" (Id. at p. 9. quoting Ericksen, Arbuthnot, McCarthy, Kearney & Walsh, Inc. v. 100 Oak Street, supra, at p. 322.) Thus, 'it is the general rule that parties to a private arbitration impliedly agree that the arbitrator's decision will be both binding and final." (Moncharsh, supra, at p. 9, fn. omitted.) for this reason, 'an award reached by an

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constituted a stipulation that Breakers did not waive its right to appeal by participating in the arbitration. The argument is disingenuous at best. First, there was no such stipulation. And second, the letter referred only to participation by the general partners, Wilmore and Mayer, whom Beakers now contends were erroneously ordered into arbitration.

arbitrator pursuant to a contractual agreement to arbitrate is not subject to judicial review except on the grounds set forth in [Code of Civil Procedure] sections 1286.2 (to vacate) and 1286.6 (for correction). Further, the existence of an error of law apparent on the face of the award that causes substantial injustice does not provide grounds for judicial review. [¶] [T]he normal rule of limited judicial review may not be avoided by a claim that a provision of the contract, construed or applied by the arbitrator, is 'illegal,' except in rare cases when according finality to the arbitrator's decision would be incompatible with the protection of a statutory right." (Id. at p. 33.)

Code of Civil Procedure section 1286.2 provides: "Grounds for vacation

of award [¶] [T]he court shall vacate the award if the court determines that: [¶] (a) The award was procured by corruption, fraud, or other undue means; [¶] (b) There was corruption in any of the arbitrators; [¶] (c) The rights of such party were substantially prejudiced by misconduct of a neutral arbitrator; [¶] (d) The arbitrators exceeded their powers and the award cannot be corrected without affecting the merits of the decision upon the controversy submitted; or [¶] (e) the rights of such party were substantially prejudiced by the refusal of the arbitrators to postpone the hearing upon sufficient cause being shown therefor or by the refusal of the arbitrators to hear evidence material to the controversy or by the conduct of the arbitrators contrary to the provisions of this

title." None of the statutory grounds for vacating the award exists here. Thus, the order vacating the award must be reversed.

Moreover, a second reason exists for reversing the order. In Moncharsh, the Supreme Court discussed the issue of whether illegality of a contract permits judicial review. There, the attorney contended the arbitrator's award was subject to judicial review because the fee-splitting provision of the agreement was illegal and in violation of public policy. But he did not contend the illegal provision rendered the entire contract or the agreement to arbitrate illegal." Accordingly, his illegality claim was an arbitrable one, and he did not waive the issue by failing to object to arbitration on this ground."

(Moncharsh, supra, 3 Cal.4th at p. 29.)

"If a contract includes an arbitration agreement, and grounds exist to revoke the entire contract, such grounds would also vitiate the arbitration agreement. Thus, if an otherwise enforceable arbitration agreement is contained in an illegal contract, a party may avoid arbitration altogether." (Ibid.; see also California State Council of Carpenters v. Superior Court (1970) 11 Cal.App.3d 144, 157.) "By contrast, when -- as here-- the alleged illegality goes to only a portion of the contract (that does not include the arbitration agreement), the entire controversy, including the issue of illegality, remains arbitrable." (Moncharsh, supra, 3 Cal.4th at p. 71; American & Nat. etc. Baseball Clubs v.

Major League Baseball Clubs v. Major League Baseball Players Assn. (1976) 59 Cal.App.3d 493, 498.)

As in Moncharsh, Breakers does not contend the alleged illegality constituted grounds to revoke the entire contract nor that the alleged illegality voided the arbitration clause of the contract. "Accordingly, the legality of the . . . provision was a question for the arbitrator in the first instance." (Moncharsh, supra, 3 Cal.4th at p. 30) The issue of the illegality of the provision is waived if it is not raised before the arbitrator. "Any other conclusion is inconsistent with the basic purpose of private arbitration, which is to finally decide a dispute between the parties. Moreover, we cannot permit a party to sit on his rights, content in

the knowledge that should he suffer an adverse decision, he could then raise the illegality issue in a motion to vacate the arbitrator's award. A contrary rule would condone a level of 'procedural gamesmanship' that we have condemned as 'undermining the advantages of arbitration.'" (Id. at p. 30, quoting Ericksen, Arbuthnot, McCarthy, Kearney & Walsh, Inc. v. 100 Oak Street, supra, 35 Cal.3d at p. 323; see also Christensen v. Dewor Developments (1983) 33 Cal.3d 778, 783-784.) As the Supreme Court stated, "unless a party is claiming (i) the entire contract is illegal, or (ii) the arbitration agreement itself is illegal, he or she need not raise the illegality question prior to participating in the arbitration process, so long as the issue is raised before

the arbitrator. Failure to raise the claim before the arbitrator, however, waives the claim for any future judicial review. " (Moncharsh, supra, at p. 31, emphasis added.)

Here, Breakers contended, and continues to contend, that the guarantee was severable, so that other provisions could survive a finding that portions of the guarantee are illegal. Thus, its failure to raise the issue of illegality precluded any future judicial review. (Moncharsh, supra, 3 Cal.4th at p. 31; see also Loving & Evans v. Blick (1949) 33 Cal.2d 603, 609; All Points Traders, Inc. v. Barrington Associates (1989) 211 Cal.App.3d 723, 738.)[5]

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5 In view of our holding, the arbitration award will be reinstated. Therefore, we do not address Breakers' claim for attorney's fees and costs. However, because we cannot conclude no

Breakers filed not one, but three separate petitions to vacate the arbitration award, alleging illegal contract, improper parties, and arbitrators' bias. In its order vacating the arbitration award, the trial court vacated the award on the ground of illegal contract, and concluded the petitions on the grounds of improper parties and bias were moot. Therefore, Breakers contends the issues raised in the latter petitions are not ripe for review by this court. However, based on the record, we may dispose of those

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reasonable attorney would find Breaker's appeal was without merit, Driver's request for sanctions for a frivolous appeal is denied. (In re Marriage of Flaherty (1982) 31 Cal.3d 637, 650; see also Portola Hills Community Assn. v. James (1992) 4 Cal.App.4th 289, 294.)

issues as a matter of law. Breakers' petition to vacate the award on the ground of improper parties was based upon its contention that its general partner, Wilmore and Mayer, were guarantors only. However, general partners of a limited partnership are bound by an arbitration agreement between the partnership and a third party. (Keller Construction Co. v. Kashani (1990) 220 Cal.App.3d 222, 229.) Moreover, in pleadings filed in the superior court, Breakers admitted that Wilmore and Mayer were parties to the arbitration agreement. Accordingly, there was no basis for the court to vacate the arbitration award on the ground that improper parties were ordered to participate in the arbitration.

Similarly, there is no merit to Breakers' contention that the award

should be vacated because of arbitrators' bias. The petition did not identify which arbitrators were allegedly biased. The sole basis for the petition on this ground was that Warren Driver, who has a major financial interest in Driver, is also a member of the American Arbitration Association panel of arbitrators and is on its regional advisory committee. However, "a personal relationship (acquaintance) between an arbitrator and a party to the arbitration does not require vacation of an award for possible bias. [Citation.] Because arbitrators are selected for their familiarity with the type of business dispute involved, they are not expected to be entirely without business contacts in the particular field. [Citation.] The fact that an arbitrator and a party to the

arbitration are members of the same professional organization 'is in itself hardly a credible basis for inferring even an impression of bias.'" (Ray Wilson Co. v. Anaheim Memorial Hospital Assn. (1985) 166 Cal.App.3d 1081, 1087-1088, quoting San Luis Obispo Bay Properties, Inc. v. Pacific Gas & Elec. Co. (1972) 28 Cal.App.3d 556, 567.) Thus, Breakers' contention that the award should be vacated because of arbitrators' bias is unsupported.

DISPOSITION

As to Drivers' appeal, the order granting the petition to vacate the arbitration award is reversed. As to Breakers' appeal, the order denying the claim for attorney's fees and costs is affirmed. Driver shall recover its costs

on appeal.

/s/ MOORE

MOORE, J.

WE CONCUR:

/s/ CROSBY
CROSBY, ACTING P.J.

/S/ WALLIN
WALLIN, J.

APPENDIX C

FILED
JUL 12 1991
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SUPERIOR COURT OF THE STATE OF CALIFORNIA
FOR THE COUNTY OF ORANGE

C. W. DRIVER, a Partnership,	)	CASE NO. 477 394
	)	DIFFERENTIAL CASE MANAGEMENT PROGRAM
Plaintiff,	)	
vs.	)	Judge Robert A. Knox
HUNTINGTON BREAKERS APARTMENTS, LTD., a Partnership, et al,	)	**ORDER VACATING ARBITRATION AWARD**
Defendants.	)	
AND RELATED CROSS ACTIONS	)	

The following listed matters came on for hearing on March 7, 1991 in Department "71" of the above-entitled court, the Honorable Robert A. Knox presiding:

1. Petition of Defendants HUNTINGTON BREAKERS APARTMENTS, LTD., WILMORE CITY DEVELOPMENT, INC., and JOSEPH P. MAYER III (collectively hereinafter "HUNTINGTON BREAKERS") to Vacate Arbitration Award (Illegal Contract)
2. Petition of Defendants HUNTINGTON BREAKERS to Vacate Arbitration Award (Improper Parties)
3. Petition of Defendants HUNTINGTON BREAKERS to Vacate Arbitration Award (Bias of

Arbitrators)

4. Petition of Plaintiff C. W. DRIVER a partnership (hereinafter "DRIVER") to Confirm Arbitration Award

5. Motion of Plaintiff C. W. DRIVER for Severance of (1) Parties and (2) Second Amended Cross-Complaint Maguire, Toghia & Orbach by Everett W. Maguire and Steven L. Chesney appeared as attorneys for Plaintiff, respondent and Petitioner C.W. DRIVER, a partnership; and Callahan, McCune & Willis by George W. Coleman appeared as attorneys for Defendants, Petitioners and Respondents HUNTINGTON BREAKERS APARTMENTS, LTD., WILMORE CITY DEVELOPMENT,

INC., and JOSEPH P. MAYER III. No other parties to this action appeared.

On December 26, 1985, DRIVER timely filed its verified Complaint (Foreclose of Mechanic Lien) and Petition to Compel Arbitration and Stay Action Pending Arbitration against HUNTINGTON BREAKERS and other parties hereto. (The original of said verified Complaint and Petition is contained in the court's file in this action.)

On February 13, 1986, DRIVER filed in this action a verified Plaintiff's First Amended Petition to Compel Arbitration and Stay Court Action Pending Arbitration. (The original of said First Amended Petition is contained in the Court's file in this action.)

On March 13, 1986, after hearing

Plaintiff's first Amended Petition to Compel Arbitration and Stay Court Action Pending Arbitration, the Court issued a Minute Order stating:

> "Plaintiff's Petition to Compel Arbitration and Stay Court Action Pending Arbitration is granted except as to the Guarantors. The Court rules that the Guarantors are not parties to the agreement to arbitrate and action is stayed as to the Guarantors." (Exhibit "D" to the HUNTINGTON BREAKERS' Petition to Vacate Arbitration Award (Illegal Contract), and

Exhibit "5" to DRIVER's Verified Petition to Confirm Arbitration Award.)

The order granting arbitration was based upon Article 7.9 of the General Conditions that are referred to in and are a part of the Standard Form of Agreement Between Owner and Contractor (referred to in Defendants HUNTING BREAKERS' Petition as the "AIA Form Agreement," Exhibit "B" thereto and Exhibit "1" to DRIVER's Verified Petition to Confirm Arbitration Award.) which provide that all claims, disputes and other matters in question between the parties thereto shall be decided by arbitration in accordance with the Construction Industry Arbitration Rules of the American Arbitration Association.

The matter was arbitrated before the American Arbitration Association, Construction Industry Arbitration Tribunal, and the appointed arbitrators made their award dated October 4, 1990. (Exhibit "A" to HUNTINGTON BREAKERS' Petition to Vacate Arbitration Award (Illegal Contract) and Exhibit "9" to DRIVER's Verified Petition to Confirm Arbitration Award.)

The Court, having considered the moving and opposing documents on each of the above-listed petitions and motion, and having heard and considered oral argument on the Petition to Vacate Arbitration Award (Illegal Contract), makes the following statement of decision and orders thereon:

1. The Petition of Defendants HUNTINGTON BREAKERS APARTMENTS,

LTD., WILMORE CITY DEVELOPMENT and JOSEPH P. MAYER III to Vacate Arbitration Award (Illegal Contract) is granted, with respect to the following relief sought in the prayer of that petition:

(a) The award of the arbitrators dated October 4, 1990 is vacated and declared void;

(b) The Court finds that those portions of the contract document entitled "Guaranty and Indemnity Agreement" (Exhibit "C" to Defendants' Petition) that obligate the parties making that agreement to the payment of any contractor-construction costs over and above the $8.6 million guaranteed maximum cost stated

in the AIA Form Agreement constitute an illegal contract and are unenforceable.

(c) The Court finds that the Arbitration Award was based in part upon those portions of the Guaranty and Indemnity Agreement described above that are illegal and unenforceable.

2. Defendants HUNTINGTON BREAKERS' Petition to Vacate the Arbitration Award (Bias of Arbitrators) is now moot and is ordered off calendar.

3. Defendants HUNTINGTON BREAKERS' Petition to Vacate the Arbitration Award (Improper Parties) is now moot and is ordered off calendar.

4. Plaintiff DRIVER's Petition to Confirm the Arbitration Award is denied.

5. Plaintiff DRIVER's Motion for Severance of (1) Parties and (2) Second Amended Cross-Complaint is denied in its entirety.

Dated: July 12, 1991

/s/ ROBERT A. KNOX
Judge of the Superior Court

Supreme Court, U.S.
FILED
JUN 24 1993
OFFICE OF THE CLERK

(2)

No. 92-1907

In The

Supreme Court of the United States

October Term, 1992

HUNTINGTON BREAKERS APARTMENTS, LTD., a partnership, WILMORE CITY DEVELOPMENT, INC., a corporation, and JOSEPH P. MAYER III,

Petitioners,

vs.

C.W. DRIVER, a partnership,

Respondent.

On Petition For A Writ Of Certiorari To The Court Of Appeal Of The State Of California, Fourth Appellate District, Division Three

BRIEF OF RESPONDENT C.W. DRIVER IN OPPOSITION TO PETITION FOR WRIT OF CERTIORARI

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QUESTION PRESENTED FOR REVIEW:

Petitioners' alleged "Question Presented for Review" is purely hypothetical and makes incorrect assumptions. In the case at bar, there is no illegal agreement, the agreement in question does not violate the principle of *D'Oench, Duhme & Co., Inc. v. FDIC*, 315 U.S. 447, 62 S.Ct. 676, 86 L.Ed. 956 (1942), there is no federal agency or lender to be protected and there is no federal law or question for determination by the Supreme Court of the United States. The transaction is complete and all that remains in this case is for Petitioners, real estate developers, to pay their contractor, Respondent herein, the $1,575,535 balance due for work performed in 1985 on their 342 apartment project as determined by three competent and experienced Arbitrators after a 130 day, 4 year arbitration trial.

PARTIES TO THE PROCEEDING.

Petitioners are real estate developers, composed of HUNTINGTON BREAKERS APARTMENTS, LTD., a California limited partnership, and its two general partners, WILMORE CITY DEVELOPMENT, INC., a California corporation and JOSEPH P. MAYER III (hereinafter collectively "BREAKERS"). Respondent C.W. DRIVER (hereinafter "DRIVER") is a California general partnership and licensed general building contractor.

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No. 92-1907

In The

Supreme Court of the United States

October Term, 1992

HUNTINGTON BREAKERS APARTMENTS, LTD., a partnership, WILMORE CITY DEVELOPMENT, INC., a corporation, and JOSEPH P. MAYER III,

Petitioners,

vs.

C.W. DRIVER, a partnership,

Respondent.

On Petition For A Writ Of Certiorari To The Court Of Appeal Of The State Of California, Fourth Appellate District, Division Three

BRIEF OF RESPONDENT C.W. DRIVER IN OPPOSITION TO PETITION FOR WRIT OF CERTIORARI

I. PRELIMINARY STATEMENT

1. Proceedings Below:

After the trial court in *1986* granted DRIVER'S motion to compel arbitration and *after* over 130 days of arbitration hearings culminating in a unanimous $3,021,502 award by three arbitrators in favor of DRIVER in *1990*, BREAKERS in *1991* for the *first time* raised the

issue of an illegality in a collateral Guarantee executed by them.

Based upon an alleged illegality in BREAKERS' Guarantee, the trial court on July 12, 1991 vacated the arbitration award, despite BREAKERS' total failure to demonstrate that the Arbitrators relied in any way upon BREAKERS' Guarantee in making their award. The trial court's order of July 12, 1991 was reversed by the Opinion below. Petition, Appendix B.

2. Opinion Below:

BREAKERS misstate the opinion below. There was no finding that the agreement was a *"D'Oench, Duhme* type contract." The Court of Appeal's November 6, 1992 reversal of the trial court's July 12, 1991 Order vacating the arbitration award was on *two* separate independent grounds. *First,* none of the California statutory grounds for vacating arbitration awards exist in this case. Petition Appendix B, page B-14. *Second,* since BREAKERS did not contend that the alleged illegality constituted grounds to revoke the entire contract or that the alleged illegality voided the arbitration clause in the contract, they *waived* the illegality issue by failing to raise it at any time prior to an adverse arbitration award under the rule stated in *Moncharsh v. Heily and Blase,* 3 Cal.4th 1, 10 Cal.Rptr.2d 183 (1992). Petition, Appendix B, pages B-16-18.

II. SUPPLEMENTAL STATEMENT OF THE CASE

The Petition omits critical facts and contains false statements. The true facts are as follows:

1. In March *1983*, BREAKERS, obtained a $16 million real estate development loan from HOME Federal Savings and Loan Association (hereinafter "HOME") for the purchase of land and the construction of an apartment project in Huntington Beach, California (hereinafter "Project"). In connection with this loan, BREAKERS executed a Promissory Note, Loan Agreement, Construction Loan Agreement and a *first priority* Deed of Trust recorded on March 11, 1983, to secure the loan. DRIVER was *not* the contractor at the time of the loan, and did *not* then or at any time sign any of the loan documents. In *1989*, the loan from HOME *was paid in full*; HOME's deed of trust was released, and HOME has no further interest in the Project or the property.

2. On or about July 15, *1983*, BREAKERS entered into a written contract with Acacia Construction (hereinafter "ACACIA"), a general building contractor, for the construction the Project. ACACIA worked on the Project from July, 1983, through March, 1984, performing grading, installing concrete piles, etc., of a value of approximately $500,000.

3. In February *1984*, ACACIA informed BREAKERS that its present estimate indicated construction costs would be at least $10.1 million and that this estimate was qualified and based upon still incomplete plans for the Project.

4. In *March-April 1984*, BREAKERS discharged ACACIA as contractor and changed architects, structural engineers and civil engineers, and asked DRIVER to assist them in the Project. BREAKERS also informed DRIVER that they were changing the plans to reduce the

construction costs to the approximate balance of $8.6 million remaining in their construction budget, that all of the principals and owners of BREAKERS would personally guarantee and agree to pay DRIVER any construction costs over the $8.6 million, and that BREAKERS had several methods of raising additional monies to make up the difference between the $8.6 million budget and the actual costs of construction.

5. Thereafter DRIVER received from BREAKERS a letter dated *April 18, 1984,* setting forth the various methods BREAKERS had in process and would use to make up the shortage of construction funds, including obtaining secondary financing and syndication, and instructing DRIVER to *"consider this (letter) as your notice to proceed"*. On *April 30, 1984,* DRIVER, began its first physical work on the Project with its own forces.

6. In April, 1984, at the request of BREAKERS, DRIVER put the project out for bid, using the still incomplete plans dated January 9, 1984 or earlier, and marked "Not for Construction". As a result of subcontractor bids and estimates by DRIVER's staff, DRIVER came up with an estimated cost of $11,519,794. Thereafter, at a meeting held on April 27, 1984, BREAKERS came up with their own estimate in the approximate amount of $10.6 million, based upon BREAKERS making several cost saving changes, some of which were already in process by their new architects and engineers.

7. *At the instruction of* BREAKERS' Steven Semingson, DRIVER on May 1, 1984 prepared a *standard AIA form Cost Plus Construction Contract* (hereinafter "Construction Contract") in the amount of $8.6 million and

had its attorneys prepare BREAKERS' Guarantee and Indemnity Agreement (hereinafter BREAKERS' Guarantee) in the maximum amount of $11 million. At the time, BREAKERS promised DRIVER that major cost saving changes in the plans would be made by BREAKERS' new design team. BREAKERS' Guarantee specifically stated that BREAKERS and DRIVER were *"working together on revisions to the plans and specifications for the project in an effort to bring lower the final costs of the project plus Contractor's fees, to as close as possible to the present GMC ($8.6 million)."* As it later turned out, DRIVER's efforts to reduce construction costs *downward* to the $8.6 million, were frustrated by BREAKERS' constant demands, additions, changes, delays, disruptions and interferences, and the enormous power and control BREAKERS exercised over DRIVER, subcontractors, architects and engineers and nearly every aspect of the Project, including the design, DRIVER's pay applications, the construction, changes, timing, subcontracts and materials. An example of BREAKERS' arbitrary control over DRIVER's pay applications is indicated in HOME's inspector's site report of August 6, 1985, wherein he stated in the first paragraph on page 2:

> "Please note that the percentage of completion dropped from the previous month, from 85% to 82%. In our opinion, the project is approximately 90% completed. No Application for Payment was made for any of the items shown in Change Order #5. Much of this work is completed."

8. Prior to the Construction Contract and BREAKERS' Guarantee, signed on May 4, 1984, DRIVER

had *no* contractual obligations or agreements with BREAKERS. The Construction Contract was a standard form (A111 and A201) of the American Institute of Architects widely used throughout the United States for decades, and contained a separate paragraph 7.9 in the General Conditions (AIA form A201) entitled "ARBITRATION". In addition the word "arbitration" is used in many paragraphs throughout the General Conditions. BREAKERS' contention on page 4 of their Petition that there was a hidden arbitration clause buried in an attachment is simply not true, nor was any such contention ever previously made by BREAKERS.

9. It was undisputed that BREAKERS' Guarantee was prepared *at the request of BREAKERS' Mr. Semingson* and contained therein the information and details he had furnished to DRIVER. At all times, DRIVER believed that BREAKERS' Guarantee was valid and enforceable, and it was always DRIVER's belief that the Lender, HOME, *was aware* of BREAKERS' Guarantee as particularly stated therein *in* the second full paragraph on page 2 thereof as follows:

> "*WHEREAS, Lender is aware* that as between Owner and Contractor, *Owner will be required to pay* any increased costs resulting from any revisions and modifications required by the City of Huntington Beach, as well as for any changes and extra work as provided in the Construction Contract and *for any excess of Contractor's actual costs plus Contractor's fee over the present GMC,*(**$8.6** million) and *that Owner will be executing this Guarantee and Indemnity Agreement, so providing* as more particularly set forth below;" (Emphasis added.)

10. When BREAKERS, et al., on May 4, 1984 signed their Guarantee, they agreed and represented to DRIVER, that *the Lender* (HOME) *was aware of BREAKERS' Guarantee* and its provisions and *that BREAKERS would be signing it*. DRIVER relied upon these representations and provisions in BREAKERS' Guarantee in constructing BREAKERS' Project.

11. BREAKERS' Guarantee was *not* a secret second agreement; it was known to HOME and was simply a *guarantee* given to DRIVER by BREAKERS, et al., guaranteeing that *if* sufficient revisions in the plans and specifications *were not made by BREAKERS* to get the cost of the Project down to $8.6 million, DRIVER would be paid for its actual construction costs, not exceeding $11 million by the persons and entities who signed the Guarantee. Unfortunately, BREAKERS did not cooperate in making revisions to lower the costs, but instead made many additions to the Project totalling $2,741,162.

12. BREAKERS' Guarantee did *not* "ostensibly increase . . . the exposure of the S&L (HOME) from $8.6 million to $11 million" as contended in the Petition at page 3. HOME's deed of trust securing the loan to BREAKERS had been recorded on *March 11, 1983*, more than a year before the Construction Contract and BREAKERS' Guarantee were signed on *May 4, 1984*, and thus HOME's previously recorded deed of trust had *priority* over any mechanic's lien rights DRIVER might have on the Project. In fact, *the value of HOME's security* for its loan to BREAKERS *would be increased* by any improvements DRIVER made to the Project, and DRIVER would not have any security by way of mechanic's lien rights for the improvements it was to make to the Project *until the*

value of the Project *exceeded* the amount of HOME's ($16 million) loan and first priority deed of trust. Thus, BREAKERS' Guarantee, could in no way harm HOME or any governmental agency but *on the contrary would greatly benefit HOME* and its security. In fact, at the arbitration trial, BREAKERS contended they had a 1985 appraisal showing a Project value on completion of *$29.5 million*. At the time of the May 4, *1984* BREAKERS' Guarantee, HOME's *$16 million* loan to BREAKERS had already been approved and funded *in 1983* and draws out of the loan had been made by BREAKERS to purchase the land, to pay ACACIA, etc. The May 4, 1984 agreements did *not* increase the amount of money HOME agreed *in 1983* to loan on BREAKERS' Project and did *not* subject either HOME or any governmental agency to further risk or liability, but rather, HOME was extremely benefitted by DRIVER's willingness to go to work and get the Project going again at a time when everyone involved knew that the construction loan budget was insufficient to pay all of the remaining costs of construction *as then designed*. If the Project had not restarted, HOME would have been left with a parcel of land with some piles (for 18 buildings) in the ground and partially completed plans.

13. At the arbitration hearing on June 22, 1989, Ms. Gloria Wolfe, HOME's Regional Manager of Construction Disbursement, *was sworn and testified*: that *she was shown BREAKERS' Guarantee* after a meeting held in San Diego *early in the job and before any major construction had started*, that *she knew the $8.6 million in the Construction Contract was not a real number*, and that *she believed* (as DRIVER had) *that BREAKERS' August, 1984, $2.52 million loan* (consented to by HOME) from Newport Balboa *was going*

to make up the difference between the $8.6 million in the Construction Contract and the $11 million in BREAKERS' Guarantee. There was no competent evidence that BREAKERS' Guarantee was not part of HOME's files as contended in the Petition at pp. 3-4. At the time of the alleged review of HOME files in 1991, many of HOME's files were missing as testified by HOME's representative at the arbitration trial on June 27, 1989. Further the 1991 review did not include 2 large boxes of HOME's files locked in a cabinet at the American Arbitration Association. Nor was there any evidence that the Construction Contract was in HOME's files or was in any way relied upon by HOME.

14. DRIVER had *no* agreements or dealings with HOME, and DRIVER's sole knowledge of what HOME might know or require was from BREAKERS' Mr. Semingson. No payments were made by HOME directly to DRIVER with respect to the Project, and HOME made all loan payments directly to BREAKERS. DRIVER made no representation to HOME that it would construct the Project for the funds remaining in the loan as alleged in the Petition at page 4.

15. The $8.6 million cost plus Construction Contract was increased by Change Orders, and by Change Order No. 5, dated July 15, 1985, *signed both by DRIVER and BREAKERS*, the Construction Contract had been adjusted to *$10,742,367.09*. In addition, Change Orders No. 6 and 7, signed by DRIVER and submitted to BREAKERS for signature and payment, increased the Construction Contract to *$12,449,161*.

16. Further, the evidence introduced at the 130 day arbitration trial showed that DRIVER performed *extra and additional work* out of the scope of the Construction Contract, in the amount of *$2,741,162* and that DRIVER had only been paid by BREAKERS the sum of *$9,363,269.78*. The Arbitrators made their decision based upon the evidence and awarded DRIVER for work performed the sum of *$1,575,535.00*, which is less than the *$1,977,892.22* difference between $8.6 million plus said *$2,741,162* (for extra work) less the $9,363,269.78 paid.

17. The trial court on March 16, 1986, ordered BREAKERS to arbitrate. The arbitration commenced in the American Arbitration Association *in June, 1986*, and *after over 130 days of arbitration trial*, resulted in a $3,021,502 Award (including interest, costs and attorneys fees) on October 4, *1990*, in favor of DRIVER and against BREAKERS.

18. BREAKERS and their attorneys at all times *prior* to the October 4, 1990 Arbitration Award and their 1991 Petitions to Vacate the Award, contended and asserted in both the Trial Court and in the arbitration that their May 4, 1984 Guarantee was valid and enforceable and provided BREAKERS the basis for their request for attorneys' fees in the arbitration and in the trial court. In fact, until BREAKERS' said 1991 Petitions, BREAKERS, et al., in signing BREAKERS' Guarantee, agreed to and represented to DRIVER the truth of all of the statements and provisions in their Guarantee, including the statement that the "Lender is aware that . . . Owner (BREAKERS) will be executing this Guarantee . . . " *After* BREAKERS lost the four year arbitration, they now say *"they lied," and* they now request the Court to reward them for *their*

(alleged) lie, by giving them a *$1,575,535 windfall* by not having to pay DRIVER *the $1,575,535 balance found to be due* by the Arbitrators *for work performed by DRIVER on their Project.*

19. The evidence at the arbitration trial also showed that BREAKERS' partners drew out $1,196,359 of project funds during construction , and steadfastly refused to invest any of *their own* money, and yet, BREAKERS ended up with a Project *they testified* had a completed value of *$29,500,000* in 1985, at the time they sold up to a fifty percent (50%) of their equity to Pacific Real Property (Pacific Federal) in *August, 1985* for *$5,500,000.00.*

20. BREAKERS' arbitration trial Exhibit HB16-153 and as testified to by BREAKERS' managing partner, Semingson, showed that the construction budget was simply the amount left over out of the $16 million HOME development loan and was not based upon any real estimate of construction costs.

III. SUMMARY OF ARGUMENT

The subject transaction and the resulting arbitration and appellate decisions do not violate the principles set forth in *D'Oench, Duhme & Co., Inc. v. FDIC,* 315 U.S. 447, 62 S.Ct. 676, 86 L.Ed. 956 (1942) and its progeny. HOME had full knowledge of the transaction, never suffered any potential or actual damages with respect to the transaction, and was paid in full. During the arbitration of this matter between DRIVER and BREAKERS, BREAKERS never raised the issue of illegality or claim that BREAKERS' Guarantee was unenforceable.

In fact, during the arbitration, BREAKERS sought to enforce BREAKERS' Guarantee through their claim for attorneys' fees. It was only *after* the Arbitrators ruled against BREAKERS and in favor of DRIVER that any alleged issue of illegality was raised. Without any showing that the Arbitrators relied on BREAKERS' Guarantee, the trial court, nevertheless vacated the arbitration award on the basis of partial illegality. The California Court of Appeal reversed the trial court on two grounds. The California Court of Appeal properly held that no statutory grounds exist for vacating the Award and that, since BREAKERS' claim of illegality went to only a portion of the contract, any such claim not raised during the arbitration was deemed waived. Under California law, issues of partial illegality are subject to arbitration. *Moncharsh, supra*, 3 Cal.4th at 30; *Green v. Mt. Diablo Hospital District*, 207 Cal.App.3d 63, 71, 254 Cal.Rptr. 689 (1989). Further, BREAKERS does not have the standing to raise any claim of the violation of "non-party" rights.

BREAKERS rely upon *Pitts v. Highland Construction Co.*, 115 Cal.App.2d 206, 252 P.2d 14 (1953), *Young v. Hampton*, 36 Cal.2d 799, 228 P.2d 1 (1951) and *McAllister v. Drapeau*, 14 Cal.2d 102, 92 P.2d 911 (1939). Those cases are distinguishable from the within action in that in those cases there was no arbitration involved, the lenders had no knowledge of the second agreement, the second agreement did not state on its face that the lender was aware of the second agreement, there was no evidence at the trial that the lender was aware of the second agreement, the parties seeking to enforce the second agreement were involved in the financing of the transaction, and there was no issue of waiver involved. Further, the within

action is virtually identical to *Shiver v. Liberty Building-Loan Association*, 16 Cal.2d 286, 106 P.2d 4 (1940), wherein the Court found the second agreement to be valid and enforceable.

BREAKERS further claim that the policies set forth in *D'Oench* and *Federal Savings & Loan Insurance Corp. v. Gemini Management*, 921 F.2d 241 (9th Cir. 1990) would not be served if *Moncharsh* is deemed controlling. However, such a claim is erroneous. First, in general, state courts and arbitrators have the jurisdiction to hear and decide all federal issues presented to them, absent specific legislation or United States Constitution provisions to the contrary. Second, unlike the within action, the *D'Oench* and *Gemini* cases are based upon (1) the bank having no knowledge of the alleged "illegal" transaction, and (2) by the lack of such knowledge, the bank was misled into making the loan. Third, BREAKERS cannot show that the Arbitrators relied upon BREAKERS' Guarantee in rendering their award. Based thereon, the Petition For Writ of Certiorari must be denied.

IV. ARGUMENT

A. THE ALLEGED LEGALITY OF BREAKERS' GUARANTEE WAS NOT REQUIRED TO BE CONSTRUED BY THE COURT OF APPEAL IN RENDERING ITS DECISION

As previously stated, the Court of Appeal held that there were *two* reasons why the trial court's order vacating the arbitration award must be reversed. The first reason given was that "None of the statutory grounds for

vacating the award [*California Code of Civil Procedure* § 1286.2] exists here. Thus the order vacating the award must be reversed" (Petition, Exhibit B, p. B-14).

The Court of Appeal, as "a second reason . . . for reversing the (Trial Court) order" (*id.*), followed the holding of *Moncharsh v. Heily & Blase, supra.* In *Moncharsh,* the California Supreme Court held, among other things, at page 31, as follows:

> "We thus hold that unless a party is claiming (i) the entire contract is illegal, or (ii) the arbitration agreement itself is illegal, he or she need not raise the illegality question prior to participating in the arbitration process, so long as the issue is raised before the arbitrator. Failure to raise a claim before the arbitrator, however, waives the claim for any future judicial review."

BREAKERS contend that notwithstanding the above-quoted language of *Moncharsh,* that the Court of Appeal was required to, but did not, construe the legality of BREAKERS' Guarantee. The Court of Appeal found that since BREAKERS claimed that their Guarantee was only partially illegal, their claim of illegality was waived because it was not raised during the arbitration.

In *Moncharsh,* the Supreme Court recognized an extremely limited exception "in rare cases when according finality to the arbitrator's decision would be incompatible with the protection of a statutory right." *Moncharsh,* at 32, *citing Shearson/American Express, Inc. v. McMahon,* 482 U.S. 220, 107 S.Ct. 2332, 96 L.Ed.2d 185 (1987). In *Shearson,* the Court held that federal statutory claims are arbitrable under the Federal Arbitration Act *unless* a party opposing the arbitration shows that it was

the intent of Congress to preclude a waiver of judicial remedies for the statutory rights in issue. *Shearson*, 482 U.S. at 225-227.

BREAKERS' claim that the Court of Appeal did not consider the issue of illegality of BREAKERS' Guarantee, and therefore did not consider whether this case came under the *Moncharsh* exception for judicial review of arbitration awards involving claims of partial illegality in a contract. BREAKERS' claim is wholly without merit. First, the Court of Appeal *did* consider the extent of the alleged illegality with respect to the subject transactions between DRIVER and BREAKERS and found that since BREAKERS was arguing the *validity* of the attorneys' fees provision in BREAKERS' Guarantee, that therefore the illegality did not go to the entire transaction. Second, BREAKERS have not claimed that arbitration was not available for the resolution of the subject dispute due to enacted statutes. BREAKERS' claim of illegality does not attack the validity of the arbitration process, it only attacks one particular provision in BREAKERS' Guarantee, which obligated BREAKERS to pay up to $11 million, plus changes. Third, BREAKERS did not file a Petition for Rehearing before the Court of Appeal seeking review of the alleged omissions and misstatements in the subject opinion. Therefore, the Court of Appeal finding that BREAKERS waived any claim of illegality is correct.

B. AS THE HOLDING BY THE COURT OF APPEAL IS CONSISTENT WITH *MONCHARSH* AND PRIOR CASE LAW IN CALIFORNIA, THE PETITION MUST BE DENIED

The waiver rule in *Moncharsh*, that a party must first raise issues of illegality before the trier of fact is consistent with prior case law. In *Fomco, Inc. v. Joe Maggio, Inc.*, 55 Cal.2d 162, 166, 10 Cal.Rptr. 462 (1961), the defendants on their motion for a new trial for the *first time* raised the issue of illegality, i.e., the plaintiff did not hold a license required by Section 1263 of the *Agricultural Code*. The California Supreme Court affirmed the judgment for plaintiff and distinguished its earlier case, *Lewis & Queen v. N.M. Ball Sons*, 48 Cal.2d 141, 308 P.2d 713 (1957), stating at page 166:

> "*Lewis & Queen v. N.M. Ball Sons*, 48 Cal.2d 141 [308 P.2d 713], relied on by defendants, is not here on point. In that case the issue of illegality was first raised *during the trial* and not for the first time on a motion for a new trial. (Emphasis in original).
>
> "None of the decided cases hold that after a judgment has been entered without any evidence having been introduced establishing illegality, the court must grant a motion for a new trial on the ground of newly discovered evidence of illegality even though the moving party has failed to show the exercise of the diligence required by section 657, subdivision (4), of the *Code of Civil Procedure*."

Thus, the California Supreme Court in *Fomco*, in *1961*, rejected the contention that a party can wait until *after* they lose in court or arbitration, to first raise the issue of

illegality. Based thereon, *Moncharsh* did not change a long standing rule of law, but rather followed prior law.

In *Green v. Mt. Diablo Hospital District*, 207 Cal.App.3d 63, 254 Cal.Rptr. 689 (1989), the Court of Appeal analyzed the illegality issue with respect to arbitrations. The court stated:

> "To avoid arbitration, the illegality 'must be such as renders the entire contract illegal and unenforceable; and that *a claim of illegality of one of the incidental clauses of the contract that fall short of affording ground for revocation of the contract is itself subject to arbitration.*' (*California State Council of Carpenters v. Superior Court* (1970) 11 Cal.App.3d 144, 157 [89 Cal.Rptr. 625].)" (Emphasis added.)

Green, 207 Cal.App.3d at 71; *accord*, *Moncharsh*, 3 Cal.4th at 30.

Thus, through *Green* in 1989, *Carpenters* in 1970 and *Fomco* in 1961, BREAKERS were put on notice that issues of illegality concerning the transaction had to be raised no later than in the arbitration trial. For BREAKERS to take the position that they were not required to raise the illegality issue on DRIVER'S Motion to Compel Arbitration in 1986, or during the 1986-1990, 130 day arbitration trial would be antithetical to the rule that arbitrators have broad powers and the power to decide and determine all issues relevant to the transaction. In *Pacific Vegetable Oil Corp. v. C.S.T., Ltd.*, 29 Cal.3d 228, 241-242, 174 P.2d 441 (1946), the California Supreme Court, in construing the predecessor statute [former *California Code of Civil Procedure* § 1288] to *California Code of Civil Procedure* § 1286.2,

held that where arbitrators consider all the evidence submitted to them and do not deny a party the right to submit evidence and present its case, no ground for vacating the award exists under the controlling statute. Further, BREAKERS sought to enforce their Guarantee and the attorneys' fee provision therein during the arbitration and even in their state appeal in Case No. G011659. Only after BREAKERS lost in the arbitration did BREAKERS first claim that a portion of their Guarantee was illegal. Without question, BREAKERS is attempting to engage in "procedural gamesmanship" which has been condemned as "undermining the advantages of arbitration." *Moncharsh*, 3 Cal.4th at 30; *Ericksen, Arbuthnot, McCarthy, Kearney & Walsh, Inc. v. 100 Oak Street*, 35 Cal.3d 312, 323, 197 Cal.Rptr. 581 (1983). BREAKERS should not be allowed to wait until after an adverse decision to first raise the issue of illegality. See *Lovret v. Seyfarth*, 22 Cal.App.3d 841, 859-860, 101 Cal.Rptr. 143 (1972), ("[a] claimant may not voluntarily submit his claim to arbitration, await the outcome, and, if the decision is unfavorable, then challenge the authority of the arbitrators to act.")

In *Moncharsh*, the California Supreme Court properly relied upon prior law in formulating its holding with respect to waiver of partial illegality claims. *Moncharsh*, 3 Cal.4th at 29-31. The rule in *Moncharsh* that the issue of illegality be raised before or during the arbitration, is sound. The issue of illegality must be raised at that time in that it puts the parties and arbitrators on notice of that issue. A more meaningful hearing can then be held to enable the arbitrator's search for the truth. As the vast

majority of arbitration awards do not have findings, raising the illegality issue at the outset gives the parties and arbitrators the opportunity to fully preserve the issue for any later judicial review. Otherwise, a meaningful review of the arbitration award on the issue of illegality cannot be had under *California Code of Civil Procedure* § 1281 *et seq.*, in that one can only speculate as to what would have been arbitrator's findings on the illegality issue. Any such speculation would be contrary to the strong public policy in favor of finality of arbitration proceedings. In order to rule upon the partial illegality issue, the court will, in effect, be required to retry the merits of the controversy. This would be completely contrary to the general rule that errors of fact and law by the arbitrator are not reviewable by the courts.

C. THERE ARE NO THIRD-PARTY OR NON-PARTY PUBLIC INTERESTS ADVERSELY AFFECTED BY THE OPINION BELOW

In California, a plaintiff must be the real party in interest with respect to the claim sued upon. In general, every action must be prosecuted in the name of the real party in interest. *California Code of Civil Procedure* § 367. Generally, a real party in interest is a person who has the right to sue under the substantive law. It is the person who owns or holds title to the claim or property involved, as opposed to others who may be merely interested or benefited by the litigation. *Gantman v. United Pacific Insurance Co.*, 232 Cal.App.3d 1560, 1566, 284 Cal.Rptr. 188 (1991).

BREAKERS claim that the rights of non-parties will be adversely affected if the *Moncharsh* rule is followed in the within action. Not only are there no "non-parties" adversely affected, BREAKERS' claim is completely contrary to California law. The protection of the nebulous "rights of non-parties", even those who have not instituted legal proceedings, will be served if illegality is required to be raised at the outset. Because of the nature of the analysis required regarding illegality based on public policy, the rights of the parties and those rights of non-parties are necessarily considered. If illegality is raised during arbitration proceedings, arbitrators will then consider the merit of the illegality issue and any overriding issues of public policy in making their award, thereby promoting judicial economy. The rights of non-parties, i.e., public policy, will be analyzed and adjudicated in the arbitration and, if necessary, in subsequent court proceedings. If a party is allowed to wait until *after* an unfavorable arbitration award to first raise the issue of illegality, public policy will not be served, because, *first* the arbitrators would be denied the opportunity to decide the issue and *secondly*, had the award been favorable, the issue of illegality would *never* be raised. Thus, public policy is much better served by forcing the parties to raise the issue of illegality at the first opportunity, rather than permitting a party (like BREAKERS) to engage in "procedural gamesmanship" (*Moncharsh*, p. 30) to raise the issue only after an unfavorable arbitration award.

Further, *parties* who fail to raise the issue of illegality before or in the arbitration should not be able to use the ruse of claiming that the rights of *non-parties* were violated as a pretext to obtaining a new trial *for themselves*

after an unfavorable arbitration award. See, *Lovret v. Seyfarth*, 22 Cal.App.3d 841, 859-860, 101 Cal.Rptr. 143 (1972). This is especially true when non-parties, such as the Lender HOME involved in this case, has not been damaged, did not rely on the $8.6 million figure in the Construction Contract or any representations of DRIVER, had knowledge of BREAKERS' Guarantee, and has been paid in full. Simply put, under the facts of this case, there is no third party to be protected from anything.

BREAKERS rely upon *Pitts v. Highland Construction Co.*, 115 Cal.App.2d 206, 252 P.2d 14 (1953); *Young v. Hampton*, 36 Cal.2d 799, 228 P.2d 1 (1951) and *McAllister v. Drapeau*, 14 Cal.2d 102, 92 P.2d 911 (1939) for the proposition that courts must be allowed to review the illegality of transactions involving loans by banks or savings and loans, irrespective of any perceptions of illegality by the parties to the arbitration. BREAKERS claim that this line of cases will "die" if courts are no longer able to review contracts which are allegedly partially illegal. However, such a position is not well taken.

Pitts, *Young* and *McAllister*, are not on point. In all three cases, the claim of illegality was raised before the initial trier of fact and the party was involved in the transactions and the claimed misleading of a lender. None of these three cases involve arbitrations or the issues of waiver. California has a strong public interest in favor of finality of arbitration. As the issue of partial illegality is one that arbitrators have the power to resolve, it is imperative that the issue be raised either before or during the arbitration so that (1) all parties have the opportunity to be heard on the issue and (2) a fully informed decision can be made and (3) the trial and

appellate courts do not have to speculate as to what extent, *if any*, the alleged illegality had on the arbitrator's decision. See, *Adams v. Murakami*, 54 Cal.3d 105, 112, 284 Cal.Rptr. 318 (1991). ("Sound public policy weighs in favor of fully informed decisions, especially when a public interest is at stake.")

Further, in *Pitts*, the Court of Appeal reversed the trial court's Order which found the entire agreement illegal and unenforceable. The Court of Appeal severed the illegal portion of the transaction and enforced the valid portion of the transaction.

Without question, *Pitts*, *Young* and *McAllister* are cases which are clearly distinguishable from the within action. In those three cases, there was no arbitration involved, the lenders had no knowledge of the second agreement, the second agreement did not state on its face that the lender was aware of the second agreement, there was no evidence at the trial that the lender was aware of the second agreement, the parties seeking to enforce the second agreement were involved in the financing transaction, and there was no issue of waiver involved.

The California Supreme Court case of *Shiver v. Liberty Building-Loan Association*, 16 Cal.2d 296, 106 P.2d 4 (1940), is directly on point and could not be distinguished by BREAKERS in state court. In *Shiver*, like in the case at bench, there were two documents. Liberty, the holder of an existing $2,228 note and deed of trust, executed a "consent to take bonds" *letter* to the Home Owners Loan Corporation, a Federal agency (hereinafter "H.O.L.C.") agreeing to accept "in full settlement the sum of $1,579.00

face value of the bonds of (H.O.L.C.) . . . and thereupon . . . release all . . . claim . . . against said property." *Id.* at 298. Liberty also executed escrow instructions giving it a $300 note secured by a second deed of trust on said property. There was *no* express approval by H.O.L.C. of these escrow instructions or of the second deed of trust, and the only evidence at the trial of any such approval was the *oral* testimony of Liberty's manager that he had discussed the matter with H.O.L.C. while in their office. The homeowner testified he "had refused at all times during the refinancing negotiations to give . . . (Liberty) any consideration in addition to the bonds." *Id.* at 297. The California Supreme Court first held that oral evidence was admissible to show the true consideration, and that Liberty was not bound by the recitals of consideration in the writing (consent to take bonds *letter*) and then affirmed the trial court's finding (based on such oral testimony that the $300 note was executed with H.O.L.C's knowledge or consent) that the $300 note and second deed of trust were valid and enforceable. *Id.* at 299-300. The California Supreme Court also distinguished its one year earlier decision in *McAllister v. Drapeau,* 14 Cal.2d 102, 92 P.2d 911 (1939) (relied upon by BREAKERS) on the grounds that in *McAllister* the $1,300 note and second deed of trust therein involved *were unknown* to H.O.L.C. (*Id.* at 300.)

A comparison between the *Shiver* case and the case a bench shows that the issue of illegality was a very much closer question in *Shiver*. *First,* in *Shiver,* Liberty *was involved in the financing,* i.e., H.O.L.C. issued and gave bonds *to Liberty* in reliance upon Liberty executing the consent to take bonds letter releasing all claim "against

said property". Whereas, in the case at bench, DRIVER was not involved in the financing, had no dealings with the lender, had no contracts with BREAKERS until over a year later and all loan payments went directly to BREAKERS and none to DRIVER. *Second*, in *Shiver*, the only evidence that H.O.L.C. was aware of the $300 note and second deed of trust was the oral testimony of *Liberty's* manager that he had mentioned it while at the office of H.O.L.C. (which oral testimony was inconsistent with Liberty's Consent to Take Bonds letter); whereas in the case at bench, not only did BREAKERS' Guarantee expressly state that the Lender was aware of its contents and that BREAKERS were signing it, but the Lender's regional manager, Gloria Wolfe, testified *under oath* at the arbitration trial extensively about HOME's knowledge of BREAKERS' Guarantee and the $11 million figure therein and that she had seen BREAKERS' Guarantee early in the job and before any major construction had started. *Third*, in *Shiver*, Liberty's second deed of trust was recorded as a second lien against the owner's property; whereas in the case at bench, BREAKERS' Guarantee did *not* constitute a lien against BREAKERS' property. The *Shiver* case was followed in *Temple v. Corporation of America*, 71 Cal.App.2d 599, 163 P.2d 67 (1945).

BREAKERS claim that the policies set forth in *D'Oench, Duhme & Co., Inc. v. FDIC*, 315 U.S. 447, 62 S.Ct. 676, 86 L.Ed. 956 (1942) and *Federal Savings & Loan Insurance Corp. v. Gemini Management*, 921 F.2d 241 (9th Cir. 1990) would not be served if *Moncharsh* is deemed to be controlling. However, such a claim is erroneous. First, state courts and arbitrators have the jurisdiction to hear and decide all federal issues presented to them, absent

specific legislation or United States Constitution provisions to the contrary. See *Tafflin v. Levitt*, 493 U.S. 455, 458-459, 110 S.Ct. 792, 795, 107 L.Ed.2d 887 (1990). Second, the *D'Oench* and *Gemini* cases are based upon (1) the bank having no knowledge of the "illegal" transaction, and (2) by the lack of such knowledge, the bank was misled into making the loan, unlike here where HOME had knowledge of BREAKERS' Guarantee, made its loan over a year *prior* thereto, and consented to a $2.52 million second loan and lien against the Project to make up the difference between the $8.6 million Construction Contract and the $11 million BREAKERS' Guarantee. Third, BREAKERS cannot and did not show that the Arbitrators relied upon BREAKERS' Guarantee in rendering their award. As the within action and the holdings of both the Arbitrators and the California Court of Appeal do not infringe upon any federal rights, the Petition for Writ of Certiorari must be denied.

V. CONCLUSION

DRIVER and BREAKERS entered into a valid Construction Contract with a valid arbitration agreement therein, and the arbitration award based thereon is valid. Further, since the (March, 1983) Lender was not misled and was fully aware of BREAKERS' Guarantee at or about the time it was executed in May, 1984, BREAKERS' Guarantee cannot be considered a "secret" or illegal agreement.

BREAKERS waited until after an unfavorable arbitration award, to first assert (in 1991) that a portion of their Guarantee is illegal on the grounds that *their representation and statement* in *their 1984 Guarantee* that the "Lender is aware that . . . Owner (BREAKERS) will be executing this Guarantee . . . ", *was a lie*. Under the doctrine of invited error and waiver, BREAKERS cannot now claim they lied in their 1984 Guarantee, and thereby benefit from their own (lie) wrong.

The cases of *D'Oench, Gemini, Pitts, Young* and *McAllister* are inapplicable in that the lender (HOME) had knowledge of BREAKERS' Guarantee, did not rely upon the $8.6 million GMC figure, and was fully paid. BREAKERS is simply seeking to avoid the payment of a just debt in the amount of $1,575,535 (plus interest, attorneys' fees and costs), which the Arbitrators found to be the balance due to DRIVER for work performed. See also *Bateman Eichler, Hill Richards, Inc. v. Berner*, 472 U.S. 299, 105 S.Ct. 2622 (1985).

The arbitration award is fully supportable on three theories (Change Orders to the contract, extra work performed and cost plus) totally separate and independent of BREAKERS' Guarantee.

Partial illegality claims not raised in the arbitration are waived. *Moncharsh* merely confirms prior California Law (*Fomco, Inc. v. Joe Maggio, Inc., supra*) and clarifies the statutory intent of *California Code of Civil Procedure* § 1281, *et seq.*

The Court of Appeal properly reversed the trial court's order vacating the arbitration award. Accordingly, BREAKERS' Petition for Writ of Certiorari should be denied in its entirety.

Dated: June 24, 1993

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